

On the rebound

In the fifth of a series of updates, BTG Financial Consulting looks at manufacturing's reaction to the Brexit vote, which produced a fall in activity and orders – followed by record gains. It may be the case that not all of the world's current woes are actually down to the UK's vote to leave the EU.

If a week is a long time in politics, a month is a lifetime in manufacturing. Reports towards the end of July, after the Brexit vote, indicated that the economy was tending towards the more doom-laden end of the forecasters' spectrum. A Markit/CIPS (Chartered Institute of Purchasing & Supply) survey of business found that both the service and the manufacturing sector had slipped into negative territory. The numbers in the Purchasing Managers' Index (PMI) were demoralising – anything lower than 50 represents contraction. The index for services was 47.4 and that for manufacturing stood at 49.1, giving a combined level of 47.7. This was a very significant fall from the previous month's 52.4 and the lowest figure recorded since April 2009.

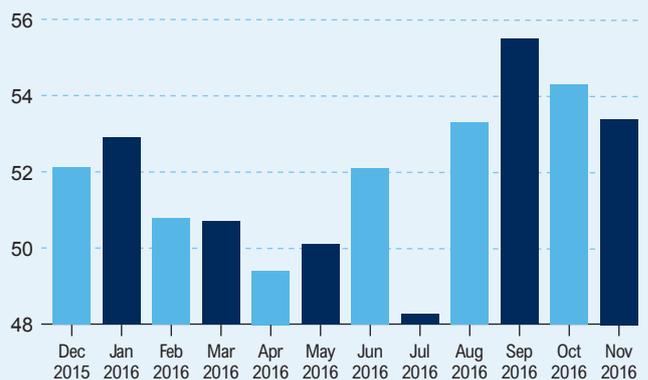
These numbers were based on less than two weeks' trading. They were collected between 12 and 21 July and were based on 85% of the usual responses. By contrast, the Bank of England's regional Agents' Summary of Business Conditions reported that: "A majority of firms spoken with did not expect a near-term impact from the result on their investment or staff hiring plans. But around a third of contacts thought there would be some negative impact on those plans over the next twelve months. As yet, there was no clear evidence of a sharp general slowing in activity." The report said that the Leave vote was expected to have a negative effect on hiring over the coming year and that some prices were expected to rise, in light of sterling's depreciation, but the "referendum result was expected to have a positive effect on export turnover over the coming year, particularly for manufacturers, as the depreciation of sterling boosted export earnings".

Markit/CIPS data for August painted a much more positive picture. The Manufacturing PMI rose to 53.3, from 48.3 in July – one of the biggest monthly jumps in the survey's 25-year history. In September, it jumped to a two-and-a-half-year high of 55.4, declining to 54.2 in October and 53.4 in November.

(See graph opposite)

Some kind of rebound was not unexpected. The ONS figures for Q2 showed that the UK had been performing pretty well in the first half of the year, with 0.4% in the first quarter and 0.6% in the second, falling slightly to 0.2% in Q3. It seems that investment decisions were postponed until the Brexit result was known.

United Kingdom Manufacturing PMI



Source: Markit/CIPS

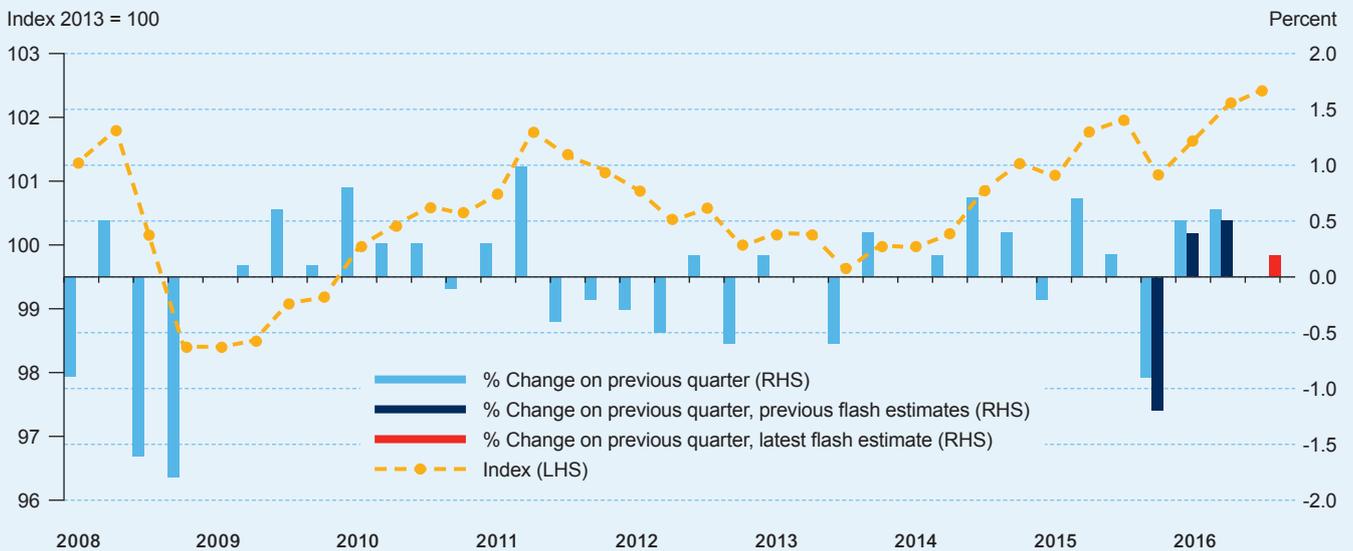
Even though it was not what the majority of businesses appeared to have wanted, at least the immediate uncertainty was out of the way. Companies reported that work that had been postponed during July had now been restarted. The domestic market showed a marked recovery, especially for consumer products. The other factor was the depreciation of sterling: businesses saw higher inflows of new business from the US, Europe, Scandinavia, the Middle East and Asia.

(See chart on page 2)

The other side of the depreciation coin is that raw materials and imported components become more expensive. Markit said that 44% of those surveyed reported higher purchasing costs in August. The jobs market was mixed, but rosier, with smaller companies hiring, while larger organisations reported job cuts.

"For home-grown high growth engineering firms, today's figures reflect in part the benefit of increased overseas revenues from a weakened sterling," Steve Lindsey, Chief Executive of Lontra, a fast-growing Midlands engineering firm observed. "In parallel to this, we need to ensure that we remain attractive to the world's best engineers so that we can continue to recruit them from both home and abroad, as we have done successfully to date."

**Percentage Change on Previous Quarter and Index of Output Per Hour
Quarter 1 (Jan to Mar) 2008 to Quarter 3 (July to Sept) 2016, UK**



Source: Office for National Statistics

Skills and Productivity Challenges

UK manufacturing has two main challenges to deal with: skills and productivity. We are producing skilled engineers, but not in sufficient numbers. We can overcome the problem – for now – by importing people with the skills we need. Over the long term, the only solution is to improve the relationships between industry and education, and encourage more youngsters to follow science, technology, engineering and mathematics (STEM) subjects. That will be a long haul.

In the economy as a whole, productivity is stagnant at best – it actually seemed to fall in the final quarter of 2015, which was the period in which the oil price collapsed, leading to decline in North Sea activity. The steel industry was also entering what looked like its death throes. It is also the case that there are some areas where improvements have been quite sparkling – automotive and aerospace, to name the two leaders. They have something in common: investment in automation. Jaguar Land Rover (JLR) is rapidly becoming the country’s most valuable manufacturer, in terms of added value, at least. Its new Ingenium engine plant in Wolverhampton, and the new lines at Castle Bromwich, Solihull and Halewood, are testaments to the value of automation. It has announced plans to create another 250 jobs at its ‘Special Operations’ facility in Coventry, and for an indeterminate number – but said to be thousands – in a future development at Whitely, near Coventry.

Invest in Automation

The UK’s suppliers have to raise their game and invest in automation in order to compete on productivity with foreign suppliers. The government offered major tax incentives through the Annual Investment Allowance but there has been no surge in investment, which is a concern. The EEF, the industry body for engineering and manufacturing employers, has found that more than eight in ten manufacturing firms plan to invest in skills to realise the potential of the so-called “fourth industrial revolution” – the Internet of Things (IoT). Its recent survey found that 51% of manufacturers said that they will need to buy new machinery and 38% said they were preparing to invest in software. The EEF said manufacturers were preparing to incorporate new technologies such as 3D printing, augmented reality and autonomous robots into their factories by 2025. The IoT may give Britain’s manufacturers an opportunity to ‘leapfrog’ a development phase, if they are prepared to use it. Nearly all machinery is now equipped with PLCs (programmable logic controllers) and many have monitoring equipment that collects data about performance, maintenance, output and other information. Adopting IoT to link them up is not the major expenditure that, say, ERP (Enterprise Resource Planning) systems were, because the infrastructure is, often, already largely in place. The appropriate technology has been put into plants almost by accident, according to Martin Walder, Vice President Industry, Schneider Electric. Investment in training is required to support industry performance because it is how equipment is used, rather than how much is invested, that will shape the industry.

“The technology itself is about integrating management information systems (MIS) with process controls and high-level SCADA (supervisory control and data acquisition) software to better manage, monitor and evaluate the manufacturing process,” said David Pickles, Managing Director at Bilfinger Industrial Services. This can range from automating maintenance and safety checks to automating the control of a production line to deal with unexpected incidents and increase efficiency. The biggest impact is often behind the scenes.

“While the UK has perhaps been a little late to embrace the possibilities of automation, we’ve caught up quickly and we’ll see a great deal of progress over the next few years as the industry understands more about what intelligent systems can deliver,” he continued, and maintained that, for all the talk about IoT and its potential, it is actually just an intermediate step in the evolution of automation. “Smart systems are the next stage, but first we need to get systems and measurements online and working together: that is the current challenge that the industry needs to focus on.”

The speed of technology adoption is accelerating. It was 20 years before 90% of US households had dishwashers; smartphones did it in just five. While IoT may have been hyped – not a ‘first’ in IT – it is making a difference and should be recognised for what it can do and how it can both make existing systems work better and how it can help UK manufacturing take a big step forward in productivity.

Manufacturing’s contribution to GDP is around 12% and it represents over 40% of exports. The EU has been taking a declining share of exports but it is still significant, at around 45%. Companies interested in exporting to the rest of the world have been managing to make headway without any official UK exclusive trade deals – not since 1973, anyway. Perhaps the wider shores of the world will become more attractive.

UK Manufacturing

Brexit came as a surprise to most and it has implications for our manufacturing base, which was already facing some severe challenges.

The effect of the decision to merge the functions of the Department for Business, Innovation & Skills with those of the Department of Energy & Climate Change into the new Department for Business, Energy & Industrial Strategy remains to be seen. Extending the responsibilities of the Department for Education to higher and further education, skills and apprenticeships, could create a more effective end-to-end view of skills and education over the longer term.

The situation with Tata Steel has still not been resolved, although the company now seems less inclined towards disposal. The British steel industry is still in intensive care, but it has not yet died.

The North Sea oil and gas industry was hit heavily by the plummet in energy prices in 2015. The North Sea itself has been declining in importance as both an energy producer and as a source of work in the supply chain. The expertise that has been built up over the past 40 years has made the UK supply and support industry a genuine global player. The decline in the value of the pound relative to the US dollar will probably be good news for this sector.

The Parliamentary Resolution to renew the Trident nuclear submarine fleet is good news for a high-skills area of manufacturing. Cumbria and North Lancashire will see the immediate benefit, with work at AWE in Aldermaston and across the supply chain secured for the next 40 years.

Boeing’s announcement that it is to establish its European headquarters in the UK is a positive, as is Siemens’ clarification of its pre-Referendum posture.

While companies such as Pfizer and Eli Lilly are scaling down their UK presence, some other companies have been going in the opposite direction – especially in life sciences and medical devices. Crawford Healthcare is blurring the lines between devices and therapies with its woundcare range. Crawford is developing dressings and woundcare systems that use non-antibiotic anti-infection approaches based on silver. Among its targets is burn care, a market worth over \$1.4 billion/year.

HS2: Schrödinger’s Railway System. Until such time as a formal announcement and commitment is made, it remains a railway that either exists or does not exist. It could be a big boost to the rail industry supply chain, including Siemens’ signals business – or it could all be diverted to HS3, proposed to run from Liverpool to Hull.

EADS (Airbus). Forecast production of the A380 super-jumbo has been significantly cut. However, the A320 continues to be an amazing success and is exceeding all expectations. Wings are made in the UK, at Hawarden in Cheshire. Aerospace is a major sector in the UK – our biggest manufacturing employer is BAE Systems.

Lowering Standards?

The UK, in the form of the British Standards Institution (BSI), is currently a full member of CEN, the European Committee for Standardization, meaning any new European standard for a product must be adopted in the UK within a set timeframe. The UK is also a full member of the International Organization for Standardization (ISO) and this will not change, regardless of the country's relationship with the EU and CEN post-Brexit.

The Brexit negotiation process as a whole is likely to be lengthy and complex.

One possible outcome is that the UK could remain a full member of CEN, in which case the current scenario on adoption of new standards would remain as it is now. However, the possibility exists that the UK could be deselected and have to reapply for CEN membership. In this instance, assuming the reapplication process were to be successful (the most likely scenario), then the UK would become a non-EU member of CEN. A number of other countries already hold a similar position, notably Turkey, the Former Yugoslav Republic of Macedonia, Iceland, Norway and Switzerland. Here, the same standards would apply as they do currently, although the EU would not be able to enforce them as rigorously as is the case now.

In the albeit unlikely event that the UK applied for readmission to CEN as a non-EU member and was unsuccessful, the anticipated outcome would be a reversion to British Standards (BS). This could affect the process of selling products into the European single market, as they would also need to conform to the relevant European standard. Where a product is covered by a harmonised standard, the manufacturer has to provide a Declaration of Performance and the product has to be CE marked. If the UK leaves CEN it would not be permitted to CE mark products being sold in the UK (unless they are being sold into the EU as well) but if UK manufacturers wanted to sell into the EU, those products would need a CE mark.

For Further Information

If you would like to discuss any of the issues raised in this update or would like to know further details about the services we provide to the sector, please contact me.



John Kelly
Partner

T: 0121 629 0705
M: 07768 337239
E: jkelly@btgfc.com

Co-authors

John Kelly has specialised in corporate recovery and restructuring since qualifying as a chartered accountant in 1977. A former partner in Ernst & Young and Kroll, he has always been based in the Midlands and as a result has a vast experience in dealing with manufacturing companies. He was instrumental in the setting up of the Advantage Transition Fund, originally created to assist the suppliers of the failed MG Rover business.

Ruari McCallion has been writing about manufacturing and business for 20 years. He has worked in financial services and as a director of an SME in SW England. He has been published in *The Manufacturer*, *Automotive Manufacturing Solutions*, *The Daily Telegraph* and other national, regional and international magazines in the UK, USA, China, Russia, Australia and South Africa.